

## **What's Ahead for the US Residential Mortgage Market**

Good morning! We gather here today at this terrific conference in good times....markets are generally favorable, the economy looks generally good. And you are involved in a segment of the market that can take significant credit for the good times we are experiencing! Over the past decade, home ownership has been steadily increasing. Much of the growth in home ownership is due to a confluence of favorable circumstances: low interest rates, abundance of new mortgage products and, for the most part, high levels of employment. Government initiatives, such as the \$200 million-per-year American Dream Down payment Act, are expected to help approximately 40,000 families each year with their down payment and closing costs. Similarly, the proposed Zero-Down payment Initiative would allow the Federal Housing Administration to insure mortgages for first-time homebuyers without a down payment. Projections indicate this could generate over 150,000 new homeowners in the first year alone. Financial circumstances and government policy support have allowed the US homeownership rate to reach nearly 70%. Countries around the world hope to replicate our success.

But we are also meeting here as we see some storm clouds gathering on the horizon. How will these new homeowners fare during an economic downturn? At what point does an "affordable mortgage" become an unhedged bet placed by an optimistic consumer? If adjustable rate mortgages reset to higher payment levels at the same time that a recession takes hold, will home property values be sufficient to bail-out the homeowner (or the lender)? More importantly, has the risk inherent in the mortgage market been sufficiently dispersed so that a sharp spike in mortgage defaults can be absorbed by the secondary market which now owns the majority of home mortgages? And finally, has the disclosure of risk been adequate or will the secondary market participants discover that they have assumed risks that they never contemplated? Do we know enough about the loans that are part of our securitizations and is the market operating with sufficient transparency to remain viable? These are some of the questions and areas I thought we could explore today.

As a former investment banker with Goldman Sachs, I am accustomed to considering these issues with an eye toward structuring marketable securities that accurately reflect their risks in the disclosures. As a former Superintendent of the NYS

Banking Department, I am accustomed to looking at this issue from the standpoint of a bank regulator concerned with systemic issues and safety and soundness.

In 2000, I engaged the New York State Banking Department in discussions with the Bond Market Association, the predecessor to today's Securities Industry and Financial Markets Association, over the appropriate role of securities underwriters with regard to sub-prime RMBS. My point then, was that underwriters should exercise a greater level of due diligence to assure that issuers were conducting business in accordance with applicable state and federal laws and in a manner consistent with fair and reasonable business practices. The concern was also that the seeds of unrecognized risks were inherent in some securitizations – an unrecognized variant of a moral hazard, if you will. So we thought there needed to be more digging into the lending practices and financial strength of originators and the characteristics of the actual collateral. In general, we believed that there needed to be more due diligence and more disclosure about the risks—to protect the market.

What was it about the securitizations that gave us pause?

Typically, as between originator and underwriter, and in the offering documents themselves, there are representations by the originator that the loans to be securitized in an offering have been made in compliance with all applicable laws. Unfortunately, however, in a number of cases, these representations and warranties were inaccurate, which led the New York State Banking Department to issue an Open Letter urging the adoption of best practices in due diligence to recognize and avert abusive and improper lending practices by originators of sub prime mortgages. We feared that the reps and warranties might set the stage for a situation where no one was minding the store, if you will. We worried about the substitution of loans in the collateral. Who was responsible for looking carefully at the underlying collateral? So, we specifically recommended that the underwriter perform a series of due diligence tests on a sample of sub prime loans in order to determine whether the representations and warranties were accurate. So, tests that included a review of credit practices for loans, and quality of originators' financial strength and compliance practices would be important.

The credit review we suggested required checking the borrower's ability to repay, credit history, and a determination that the loan amount was supported by an accurate appraisal. The compliance review we suggested required checking the agreements between the borrower and issuer including the determination that documentation was completed properly and revealed no obvious irregularities, a check that all disclosures required by law reflected the relevant transaction, and a verification that the loan terms reflected the quality of the credit. We also recommended due diligence with respect to the quality and standing of originators of loans, including reviewing outstanding complaints.

At the time, for some very good reasons, the Association disagreed with our position. The Association's position, then and presumably now, is that underwriters are not regulatory enforcement agents and that requiring underwriters to perform a substantial due diligence to determine compliance with predatory lending guidelines would be adding great cost and ultimately causing capital to flee this market.

Meanwhile, the mortgage market (especially the sub-prime component) was experiencing rapid growth. In the years since we made these suggestions, Wall Street has embraced every variant of "affordable" mortgages originated by lenders. The result has been tremendous liquidity which has enabled lenders to continue lending and innovating. But now we are seeing the consequences of some loan origination practices and undetected fraud that has taken place in the past few years. Mortgage delinquency now stands at its highest level in five years. Moreover, those parts of the country which have experienced the highest home price appreciation are also the areas that have seen the greatest increase in delinquency levels. Undoubtedly, some portion of the increased delinquencies is due to speculators in these "hot" markets. But it seems equally likely that the increased delinquency level is a symptom of the use of "affordable" mortgage products by consumers to buy into markets they otherwise could not have afforded, and in some cases are even the result of "made to order" appraisals. In a booming real estate market, concern about predatory lending and mortgage fraud may have seemed paternalistic. In a cooling real estate market, this looks more like enlightened self interest.

George, I remember a very spirited debate with you, and you were right about avoiding over-regulation. You were also right that more due diligence and transparency

were important factors for maintaining a viable market. We agreed that it just made good business sense!

Before we go much further in this discussion, perhaps we should briefly summarize the major characteristics of “predatory loans.” There is nothing wrong, and indeed much that is good, with trying to make mortgages more affordable to consumers. So what features and practices cause the most concern with regulators? The appendix to part 30 of the OCC regulations and guidelines concerning residential mortgage lending specifically focus on some of the features or terms common to predatory lending. Here are some of the regulatory “hot buttons”

- Financing single premium credit life, disability or unemployment insurance as part of the mortgage;
- Negative amortization;
- Balloon payments in short-term mortgages;
- Prepayment penalties that are not limited to the early years of a loan;
- Default rates that are not commensurate with risk mitigation;
- Call provisions permitting the lender to accelerate payment for circumstances other than the borrower’s default;
- Absence of any proof that the lender considered the consumer’s ability to repay the loan in accordance with its terms;
- Mandatory arbitration clauses;
- Terms that result in the loan falling under the Home Ownership and Equity Protection Act (HOEPA);
- Original principal balance in excess of appraised value;
- Payment schedules that consolidate more than two periodic payments and pay them in advance from loan proceeds;
- Payments to a home improvement contractor from the proceeds of a residential mortgage loan other than by an instrument payable to the consumer (or jointly to the consumer and the contractor).

The Appendix goes on to comment that beyond these items, lenders must use “Enhanced Care” particularly when they are dealing with consumers “who are not financially sophisticated, have language barriers, or are elderly, or have limited or poor credit histories, are substantially indebted or have other characteristics that limit their credit choices.” In other words, what we would normally call “sub prime” borrowers.

Although banks and other lenders play the key role in the home finance market, it is now well understood that the health of the US consumer is largely tied to the health of the housing market and, accordingly, virtually every segment of the economy has a vital interest in this sector. The explosive growth in the home equity finance marketplace is testament to the fact that the US consumer has grown comfortable with the concept of a house as an ATM machine. A robust housing market and a robust employment market have combined to produce tremendous consumption and have been a driver of domestic growth. Many cars, vacations, college educations and other consumer desires have been purchased using the equity embedded in our homes.

Concurrent with the proliferation of new affordable mortgage products, the capital markets have become increasingly involved in providing the long term, permanent capital to the US homeowner. Between 2000 and 2005 the total dollar value of US home mortgages for one to four family homes grew from four trillion dollars to over 8 trillion dollars. According to the Federal Reserve Z1 statistical release of December 2006, the portion of the 1 to 4 family residential mortgages financed by the capital markets was three times the size of the financing supplied by the commercial banking, savings institutions and credit unions combined. From just 2002 to 2005, the capital markets increased its share of the mortgage marketplace from 56% to over 60%.

No one is surprised at the size or sophistication of the US residential mortgage backed securities business. Ever since Lew Ranieri sold the first mortgage backed security in 1979, the capital markets have embraced the mortgage market and have become the ultimate source of funds for mortgage lenders. But perhaps the market has become too sanguine about the credit quality of the securities. Has the stellar performance of the investment grade MBS market lulled investors into complacency? What level of diligence is being exercised by investors? Is the market operating with transparency about the reality of the underlying loans so that appropriate due diligence

can be done? More immediately, how effective have the primary lenders – the mortgage originators – been at evaluating and managing the credit risk?

According to the Federal Reserve Board, during the period from 2002 to 2006, the net charge off rate on 1 to 4 family residential mortgages for all commercial banks ranged from 12 basis points to a high of 33 basis points. Clearly, the performance of the mortgage market has been exceptionally good. Nor does this seem to be anomalous behavior; if we look at a longer time period from 1991 through 2006, the range is only fractionally wider, with a high charge off rate equal to 44 basis points in the fourth quarter of 2001.

Does this mean that US lenders are exceptionally good at extending mortgage credit to consumers, or is it more a function of the home price appreciation that has been relatively strong for the past decade? Based upon my tenure at the NYS Banking department, and now based upon my work with Promontory Financial Group, I have seen cases where very strong credit performance could not be attributed to the credit risk management systems in place. I have reviewed operations where the independent credit risk management in place was not properly functioning, and so could not take credit for the good credit performance of the portfolio. They always say it is better to be lucky than good, right? Well, in my book it probably makes sense to be both lucky AND good....so let me share this. Some of the areas of weakness that I have seen over the years include a lack of focus on the strength of the originator/servicer, and improper analysis of the substitution of good loans for bad. We have seen re-aging policies not being properly analyzed. In fact, investment in this area has been largely driven by mathematical formulations without enough qualitative analysis of operations and financial strength. For example, we have conducted reviews of portfolios and seen residuals on balance sheets that do not reflect enough financial strength to continue operations effectively. If the shop is closed, the Trustee comes in, the re-aging practices (and other practices) are halted...delinquencies roll in, and the rest, as you know, is history. The banking regulators are paying attention, too. In recent examinations the regulators have really gone back to the basics, back to the bread and butter of examination, really, and are examining loan administration credit approval processes and credit risk management with some vigor.

Still, the performance over the past decade would not seem to indicate that there is something wildly amiss with the home mortgage lending industry. So, perhaps, there is really nothing to worry about, after all? No less an authority than Federal Reserve Governor Mishkin, in a speech just last month, pointed out how the bursting of asset bubbles generally does not lead to financial institution instability. In part, he said,

*There are even stronger reasons to believe that a bursting of a bubble in house prices is unlikely to produce financial instability. House prices are far less volatile than stock prices, outright declines after a run-up are not the norm, and declines that do occur are typically relatively small. ...Hence, declines in home prices are far less likely to cause losses to financial institutions, default rates on residential mortgages typically are low, and recovery rates on foreclosures are high. Not surprisingly, declines in home prices generally have not led to financial instability. The financial instability that many countries experienced in the 1990s, including Japan, was caused by bad loans that resulted from declines in commercial property prices and not declines in home prices.<sup>1</sup>*

In a similar vein, Standard and Poor's said in a presentation in December 2006, that compared to other real estate corrections, this time, "The Bubble May Not Pop." S&P, and virtually every observer of the housing marketplace, has noted the existence of geographic areas where housing prices have increased so dramatically that home prices are now outside of their historic relationship to other metrics (such as median income). Yet, it appears that some of the markets have already started a process of price correction. Certainly some of the more speculative practices of the past few years – remember house or "lot" flipping?—already seem like something from another era.

So let's pause for a moment and summarize a few key points:

- First, the American Dream is alive and well with home ownership at or near an all-time high;

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<sup>1</sup> Federal Reserve Governor Frederic S. Mishkin, speaking to the Forecasters Club of New York, New York, New York on January 17, 2007.

- The existence of relatively lower interest rates, by historical measures, over much of the past decade combined with new mortgage products have made the American Dream more affordable;
- The growth in the secondary market for all types of RMBS has liberated the originators of new mortgage loans since they are no longer constrained by the size of their balance sheets;
- This has resulted in a long period of home price appreciation, which can be thought of as part of a self-fulfilling prophecy:

<p>New buyers + New capital = New housing demand New housing demand leads to Home price appreciation Home price appreciation leads to more new buyers!</p>
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Maybe we will be lucky, and the cooling home market will be gradual enough so that there is minimal dislocation. If interest rates can remain at relatively low levels, if employment can remain relatively healthy we can gradually return to a period of more normal home price metrics.

But there is another scenario we should consider, not because it is more or less likely than this optimistic scenario we have been discussing, but because it is one where our actions may have a profound influence on the future of the industry. I'd like to pose a question to the audience: what could possibly erode the participation of the capital markets in the funding of residential mortgages? And a follow on question: How would such a contraction in funding likely play out? And then lastly, what can we be doing to protect ourselves?

Arguably, fixed income investors in RMBS are some of the most sophisticated and stable financial institutions in the world and are highly unlikely to curtail their involvement in the mortgage sector altogether. But what might cause them to rethink or reallocate capital away from the mortgage arena?

In general, institutional investors are capable of taking financial risks. Credit risk, prepayment risk, interest rate risk even regulatory risk, are all sources of potential loss that investors knowingly accept. All of these risks are bearable by investors if they have confidence that the relevant information is adequately disclosed so that they can make a judgment. However, if predatory lending laws evolve to extend assignee liability to purchasers of RMBS, unless they (or the underwriter) have complied with a due diligence standard, the consequences will be far-reaching. If investors begin to feel that the disclosures have been inadequate or that the due diligence framework has been inadequate, then the result would be a foundation shaking loss of confidence.

The potential loss of confidence is manifested in other ways. A widespread perception that consumers are being treated abusively elicits a regulatory response that may have unintended consequences. On November 29, 2006, the Supreme Court heard oral arguments in the case of *Watters vs. Wachovia Bank*. The case concerns a Wachovia Mortgage lending company which had been licensed under Michigan's Mortgage Brokers, Lenders and Servicers Licensing Act. The Company notified the State that it had become a wholly owned subsidiary of Wachovia Bank, and was therefore surrendering its Michigan license. As part of a national bank, the mortgage company assumed it would operate under the purview of the OCC as a national bank. Michigan's Attorney General, E. John Blanchard, cited a need to "have a say" in mortgage lenders operating within the state, particularly to be able to deal with issues of *fraud and deceit* in mortgage transactions. Should the Supreme Court not uphold the OCC national bank exemption, the consequences would be far reaching and could seriously impede mortgage operations for many multi-state lenders. And the Congress is certainly scrutinizing predatory lending practices ever more closely and the result may be legislation that seeks to curb certain practices and has the effect of limiting business that can be conducted.

In general, concern about mortgage fraud and deceit is not unfounded. In November, 2006, FinCen (the Financial Crimes Enforcement Network) published a study examining trends in mortgage loan fraud. The study was based upon the national database of Suspicious Activity Reports (SARs), related to suspected mortgage loan fraud, filed between April 1996 and March 2006. The search turned up 82,851 suspicious activity reports related to mortgage fraud, and the study group then performed additional analysis

on a random sample of over 1,000 of these reports. In the context of the enormity of the mortgage marketplace, these numbers may not seem startling. However, the rate of increase of SARs reports related to mortgage fraud was increasing at an alarming rate. Between 2003 and 2004 SARs filings related to mortgage fraud increased over 92%, far in excess of the growth in loan volume (though that was quite dramatic as well at over 33%.)

Why is mortgage fraud increasing at such a rapid rate? One reason may be that it is relatively easy to perpetrate. Consider, for example, one common type of mortgage fraud: collusion between a mortgage originator and an appraiser. In the FinCen study, appraisal fraud was often found in connection with property flipping. In these cases, the fraud was perpetrated with the collusion of mortgage brokers, appraisers, borrowers and often real estate agents/brokers. As long as property values hold up (that is, as long as hot markets stay hot) the fraud may never be detected since few lenders will go back to review an appraisal (unless the loan has gone into default). Some of the State AGs are particularly concerned about the appraisal problem, and they are focused on the criminal aspect of this fraud. In Iowa, for example, there is likely to be a new stronger statute that will elevate appraisal fraud by making it a criminal offense. I know that the AGs are willing to work with the industry to come up with procedures to safeguard against appraisal fraud.

In addition to the relative ease of mortgage fraud, consider the current regulatory regime which exists for mortgage brokers. According to the National Association of Mortgage Brokers, as many as two thirds of all mortgage loans are originated by mortgage brokers. Now consider that:

- There are no national standards for licensing or oversight of mortgage brokers;
- Some states license offices, but not individuals;
- 24 states have no specific educational or experience requirements for mortgage brokers; and
- Only a few states require criminal background checks on mortgage brokers.

Nor is mortgage fraud limited to appraisers and mortgage brokers. The FinCen study also found instances of fraud perpetrated by identity theft, by exploitation of the elderly as well as that old standby -- material misrepresentation/false statement. Of course, with certain loan programs (No Income / No asset verification mortgages, for example) it would seem the temptation to exaggerate, if not lie outright, may be too hard for some to resist.

Fraud is an important issue, particularly with regard to how it may impact the capital markets financing of home mortgages. Every RMBS transaction has representations by the seller attesting to the legitimacy of the mortgages (such as reps about compliance with all consumer lending laws and regulations, or that the loan is a valid and binding legal obligation) sold to the trust. Breaches of representations may typically be "cured" by a seller repurchase of the defective loan. In fact, several sub-prime mortgage originators recently experienced a dramatic increase in the amounts of loans they were required to repurchase due to a breach of a loan eligibility criteria rep. It is difficult to estimate the potential overhang from the repurchase obligations arising for fraudulent mortgages, however, since the repurchase obligation arising from fraud never expires. So again, it may well be that enlightened self-interest can play a role in maintaining a strong secondary mortgage market. Underwriters and originators can increase their vigilance with respect to ferreting such fraud out of the securitization market.

Given the huge impact that the cash CDO market has made, mostly as a buyer of BBB tranches of sub-prime RMBS, the increasing fraud rate may have an additional consequence. The CDO market has largely facilitated the boom in overall capital markets funding of mortgages by their voracious appetite for the riskier portion of the capital structure. If the fraud problem continues to worsen, CDO managers may start to reallocate capital away from RMBS to other asset classes by not funding incremental deals. Even if the seller cures the breach, at some point the CDO buyers may begin to lose confidence in the integrity of the underwriting process.

Part of the genius of securitization is the ability to reallocate risks so that investors may absorb greater or lesser degrees of credit risk as fits their appetite. Since the CDO managers have profited by seeking the better yielding (more risky) tranches of

transactions, they will likely feel the effects of asset deterioration before other investors. The risk is that a withdrawal or retrenchment by the CDO managers may start a domino effect: fewer BBB buyers causes an overall slow down in RMBS issuance, which causes a slowdown in loan sales, which causes a slow down in originations since seller's become balance sheet constrained if they cannot sell loans into the capital markets. In a perfect storm scenario, just as the prior years' ARM mortgages are re-pricing, consumers will have fewer refinancing choices if lenders have begun to retrench.

But a slowdown in new mortgage originations is not likely to be evenly dispersed. The mortgage products which are most likely to be withdrawn during a liquidity crunch are those very "affordability products" which now, in hindsight, look suspiciously like "predatory lending" to regulators. That is, the credit crunch is borne by those least able to withstand it and the consequence is increasing losses.

Something like this seems to be the way Ownit Mortgage met its demise. Deteriorating credit performance for their originated portfolio led to a credit crunch when its capital market participants required it to repurchase loans. According to press reports, at the time of its bankruptcy filing, creditors were seeking to have Ownit repurchase nearly \$170 million in mortgages. Nor is Ownit an isolated case. In the last two months the list of sub prime lenders that have closed shop includes: Mortgage Lenders Network, Rose Mortgage Corp., Equibanc Mortgage Corp., Funding America, Secured Funding Corp., Harbourton Mortgage Investment Corp., Sebring Capital Partner and Popular's non-prime wholesale mortgage business. Other sub-prime lenders may be able to avoid this fate by pursuing strategic alternatives such as selling out to a Wall Street firm or to a diversified financial lender. Currently, Option One, Ameriquest and ResMAE are all reportedly pursuing strategic initiatives.

Now, I'm not saying that this "perfect storm" is likely to happen on a systemic basis. But it certainly seems a plausible scenario. If this scenario does unfold, it will be very difficult to stop the spiral of losses. Eventually, the credit losses will work their way through the system and the markets will revert to the mean. But until that time, as an industry, perhaps we should focus our efforts on the consumer, the ultimate customer. What are some of the steps we can take voluntarily to improve the climate?

At the end of last year, Fannie Mae announced that it would transition to a new, single family master trust agreement which better explained and clarified its roles (as issuer, master servicer, guarantor and trustee) and also better explained and clarified the obligations of the “Direct Servicers” performing many of the day to day functions. This attempt at increasing the transparency of relevant information is a positive step.

The recent implementation of Regulation AB seems similarly intentioned. The ABS market has grown up and a greater level of standardization in the type of information disclosed is warranted. Reg AB seems particularly useful in forcing key transaction participants to affirmatively state the actions they have taken and further requires various levels of certifications. Moreover, while many issuers provided static pool analysis, the requirement of providing static pool data and the greater uniformity in how it is presented will be very helpful to the secondary marketplace.

While the due diligence proposal we made back in 2000 seemed too problematic for the industry to adopt then, perhaps it is time to revisit the basic idea we were advancing.

Specifically, perhaps underwriters should voluntarily choose to sample the sub-prime loans in any given transaction in order to assure the loans are not abusive? Perhaps greater transparency on the underlying collateral could be provided in the deal documentation so that risks can be more readily identified. Perhaps originators may take the lessons of the Ownits and consider conducting reviews of their lending practices and their risk management systems to identify gaps to best practices. In the course of doing such reviews for originators, we have seen situations where excellent policies and procedures were not being followed in practice in the field. Remediating such situations can save an institution from suffering severe financial difficulties, regulatory fines as well as blows to its reputation. This certainly falls in the category of an ounce of prevention is worth a pound of cure.

And just because an originator may represent that a loan is originated in conformity with all applicable laws and regulations does not mean that the underwriter should not make its own independent judgment about the loans. And lastly, are we inviting outsized risks into our marketplace when we securitize low FICO score, high LTV, negative amortization loans?

Increased due diligence and greater transparency about the underlying collateral in RMBS can protect investors, maintain investor confidence, and help to maintain a liquid and stable market. Such diligence and transparency in our deal documents can also help ensure that issuers do not become overly aggressive in their lending to those in pursuit of the American Dream. We can maintain the viability of a mortgage marketplace that is the envy of the world and at the end of the day, through enlightened self-interest, have a win-win situation.

Thank you and enjoy the conference.